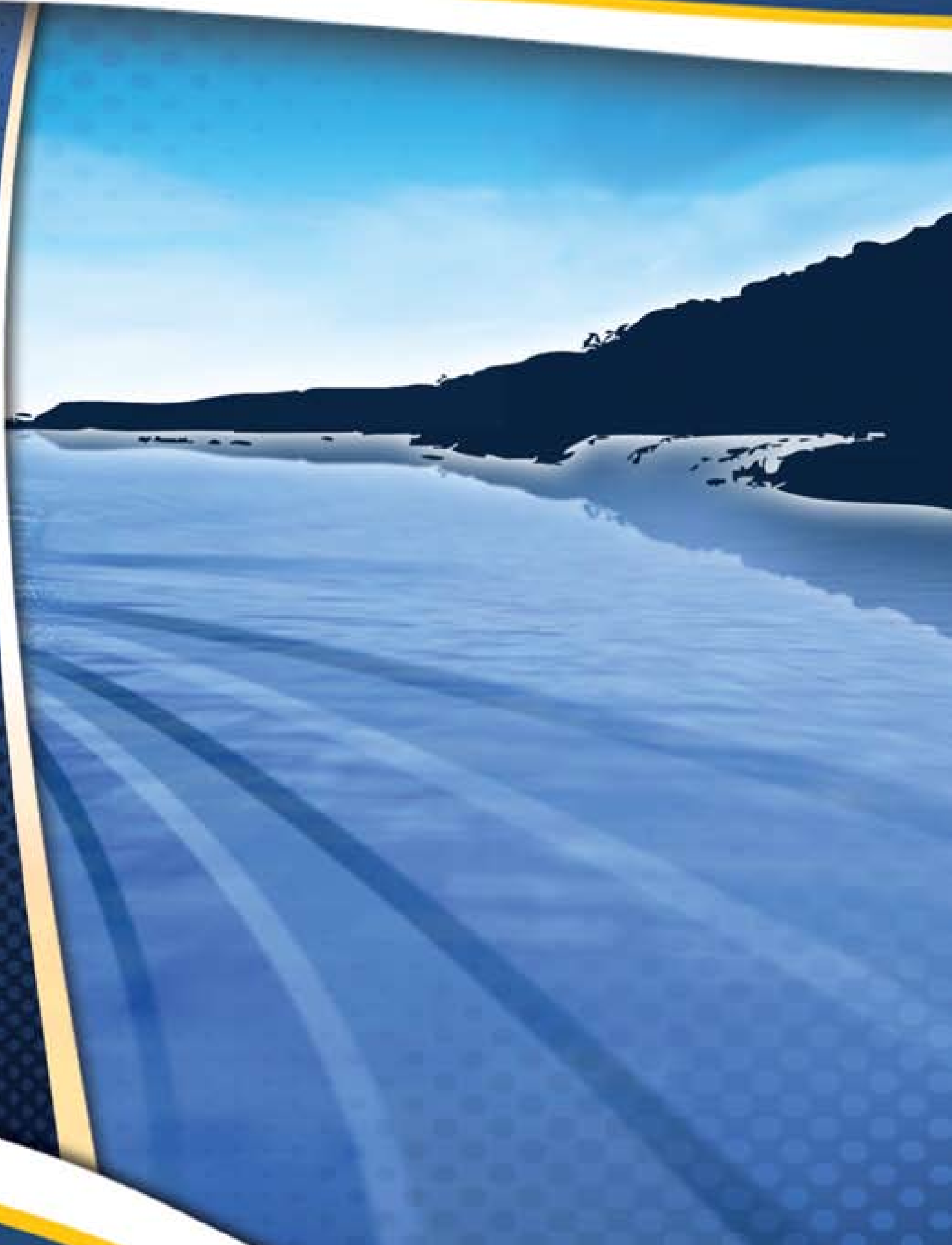
"Currents"

Toward Optimal Human Capital Performance



How Aligned Incentives Produce High Performance

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Introduction

Organizations are dynamic, ever-changing and evolving over time. To be successful, companies must *think* directionally, advance toward goals, and keep things *moving*. Progress requires movement.

Just like the companies that employ them, workers have their own motion. The engine that propels a company forward is made of workers applying human capital to their jobs, making decisions, and doing work. A company that encourages and captures the full momentum of its workers will achieve dramatically higher rates of output and better results. However, some leaders and managers have greater success than others in building positive, cohesive movement in their workers. What factors create productive momentum?

Imagine that each company is a river with a smooth surface. Employees set their boats in the water and begin paddling in a specific direction. From an observer's perspective, employees on one river may appear to be paddling hard but not making significant progress toward company goals. He may conclude that these workers must lack motivation or paddling skill. On another river, which looks identical, our observer may see workers taking their boats quickly toward the desired destination with what appears to be little effort. Ah, he perceives, these must be the right kind of skilled, dedicated workers.

But what if an invisible current below the surface of each river determines the collective progress of the paddlers—not just their skill or their motivation?

"Currents": An analogy for the incentives that influence worker behavior.

In reality, few companies achieve a desired level of human capital performance, partly because underlying incentives discourage ideal human capital performance. These incentives, defined in every employment agreement, include everything from medical benefits to time off and bonuses. Like the current of a river, combined incentives act with forces that influence worker behavior. The current can flow in either a positive or negative direction, with weak or strong force.

This paper uses economic examples to describe how organizations—sometimes unintentionally—create powerful incentive currents that affect worker behavior. Currents can be subtle and unseen, operating just below the surface. When a seemingly unrelated set of policies combine, they create extraordinary influence over the direction of collective workforce achievement. When designed within a climate of positive, aligned incentives, currents produce high performance and lower use of benefits. When misaligned, the same currents undermine workforce productivity and corporate success.

Although often invisible to observers, the current of collective incentives may have the most dramatic impact on human capital performance, more than any individual employee characteristic. Because currents exert force on an entire workforce, efforts to change individual behaviors one-by-one (especially in the opposite direction) are largely ineffective.

First, the goal: optimal human capital performance

If organizations can readily influence worker performance, it helps to clearly define the characteristics of desired human capital outcomes. What behaviors should currents encourage? We define optimal human capital performance as having the following features:

- High levels of job performance
- Low levels of unplanned absence
- Optimal turnover and job fit
- Strong human capital growth
- Active human capital protection
- High worker self-sufficiency
- High engagement in employer-sponsored initiatives
- Strong company performance

The Power of Incentives

How does a corporation achieve these outcomes described as optimal human capital performance? Further, how can a company maintain a continuous current pulling in that direction? We begin by explaining the power of incentives and the necessity of their alignment.

Workers respond to corporate incentives. It's that simple. Behind every "dedicated" worker is an opportunity for personal gain in the form of money, recognition, security, or something else he or she values.

At work or elsewhere, human decisions and behaviors are guided by a desire to maximize wellbeing and minimize losses. This is not a judgment that people inherently are selfish, but instead an acknowledgment of human nature and proven economic theory. We each weigh the value of our options and respond accordingly.

Incentives create currents. Policies that align incentives with optimal human capital performance pull toward desired goals. Policies that misalign incentives counter to optimal performance, undermine success. Multiple incentives aligned in the same direction combine with a multiplier effect, strengthening the current. Where misaligned incentives pull and push against one another, the current is weakened and less effective in moving employees toward productivity. *Incentives create currents that explain the collective behaviors of a workforce.*

How Incentives Work

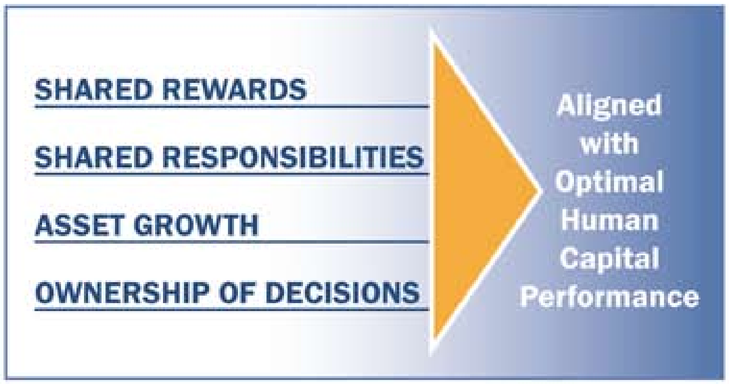
Currents consist of forces resulting from policies and practices that dictate all that a worker **has to gain, has to lose, has to protect, and gets to choose.** The direction and strength of currents will influence the likelihood of virtually every important worker action. Unless decision makers design their policies and benefits purposefully in ways that align with optimal human capital outcomes, they often create misaligned currents that silently and invisibly work against positive outcomes. The organization must align what workers have to gain, have to lose, have to protect and get to choose with company success. Then, all currents pull in the direction of constructive, productive behaviors.

Four types of currents combine to determine workforce performance.

Four Important Currents To Align with Optimal Performance

Each current contributes to the collective directional "pull" on workers; each determines which way behaviors will "drift."

Shown here, they are listed in the order of greatest potential influence, with shared rewards and shared responsibilities having the greatest pull.



Current Type 1: Shared Rewards (Something to Gain)

"My success is your success." This is the essence of Shared rewards. Any incentive that confirms to workers that the company's good fortune will translate directly into personal gain, and vice versa, is a shared reward.

There is no better, more direct positive incentive than variable pay, where a part of compensation is specifically determined by performance. The most powerful incentives are significant financial rewards that are directly tied to individual performance and allow workers substantial discretion in how they do their jobs.

How does a strong, aligned shared-rewards current affect optimal human capital performance? Most obvious, shared rewards increase work output. Reports indicate that heavily tying pay to performance increases worker output by 44% to 400%, depending on the type of job (1, 2). Further, in our own research we have compared workers receiving variable pay against those who do not in the same organization; those receiving variable pay perform more profitably per labor-hour (3). Studies indicate that profit sharing increases overall company productivity between 3% and 9% (4, 5). Clearly, if an employee earns more for working harder, the resulting current pulls an entire workforce toward better performance.

My Success is Your Success

There are many other ways that companies can share rewards with their employees:

- Give cash back for unused sick leave;
- Establish employee-owned health savings accounts (HSAs), where unused dollars for healthcare accumulate in a worker-owned account;
- Make employer deposits in HSAs;
- Offer special health insurance policies with a lower deductible to employees who maintain healthy lifestyles; and
- Allow employees to share an unused portion of the travel allowance

Although these are not as powerful as variable pay, these do contribute to the strength of a shared-rewards current.

The shared-reward current extends positive ripples to other behavior patterns beyond performance as well. Incentives that reward high performance influence worker decisions in all aspects of the job. Consider the list of behaviors on the next page that become more likely under a shared-rewards scenario.

Behavior	Connection to Shared Rewards	Direction of Current
Attendance	If I am at work, I have potential to earn more	Attendance more likely
Skill Training	If I am more skilled, I may be able to produce more output, and have potential to earn more	Skills acquisition more likely
Healthy Habits	If I feel good, I have potential to produce more, and have potential to earn more	Healthy choices more likely
Recuperation	If I get back on my feet quicker, I can return to work and earn more	Faster recuperation more likely
Overcome Work Challenges	If I can resolve this issue, I can produce more, and have potential to earn more	Efforts to solve problems more likely
Retention	I know I am rewarded for my high performance, and I feel valued	High performers more likely to stay
Turnover	I know I need to work really hard or learn new skills to make more money	Poor performers more likely to quit
Efficient Work Choices	If this project doesn't increase output, it's a waste for me and the company, and I will earn less	More efficient work decisions likely

Current Type 2: Shared Responsibilities (Something to Lose)

Shared responsibilities allocate some portion of negative consequences for undesirable outcomes to the worker. Essentially, a worker decides: I don't want to do that because it will cost me.

Shared responsibilities represent a cost-share on lost time or expenses. Perhaps the most powerful contributor to this corporate current are rules regarding paid time-off. In a perfect arrangement of shared responsibility, we would follow a simple rule "A day's pay for a day's work." By not paying a worker for days he does not work, the worker experiences a loss equal to the output lost by the employer.

With no pay for absence at one extreme and 100% pay for absence at the other, there are several incremental ways to increase the current of shared responsibility as it pertains to paid time-off.

- Paid-time-off (PTO) banks give employees a set number of combined paid days-off that can be used for vacation and sick leave as needed. While not a direct financial cost to employees, using a sick day requires giving up a future vacation day. In essence this is a cost-share of days.

- Provide less-than-full pay during extended absences. Rather than paying 100%, employers can offer 80%, 60%, or less. As such, employees share financial responsibility during a time that they produce no value to the organization. Our analyses demonstrate that such policies measurably decrease absence (6, 7).

- Require employees to pay a larger cost-share on medical insurance, or pay an additional premium on short-term disability if they wish to "buy-up" to higher coverage. These costs remind employees that benefits are not free, but represent a portion of compensation that detracts from funds available for wages.

Combining Shared Rewards and Shared Responsibilities Strengthens Currents

While both kinds of incentives affect human capital performance individually, their combination decides the strength and direction of the collective current. Naturally, if one current is weak, the other will have more pull. For example, in the absence of rewards, companies will find its current dominated by policies regarding shared responsibility. This arrangement often provokes mistrust between employers and workers, because workers feel they have more to lose than gain. While our empirical analysis shows that optimal human capital performance requires shared responsibilities, the balance is critical.

**Combined and aligned,
Shared Rewards
and Shared Responsibilities
combine to create a powerful current.**

Current Type 3: Personal Asset Growth (Something to Protect)

Corporations create a third type of current by facilitating workers' growth of personal assets. By assets, we mean both money and human capital assets, like skills, motivation, and health. Asset growth benefits both workers and employers and serves several purposes. Growth in human capital assets improves worker capacity—more skills, better health, and greater motivation all lead to better output. As assets grow, the person becomes more valuable to himself and his family, while also increasing his value to his organization. Another component of asset growth is actual monetary savings the worker can use for retirement or some other purpose. Having assets promotes self-sufficiency and choice.

What policies and practices contribute to personal asset growth?

- Employers offering a maximum match on 401K investments
- Liberal deposits in health savings accounts
- Training and educational tuition reimbursement
- In health, asset growth includes allowing opportunity for practicing healthy behaviors.

Whether there are actual programs, subsidized fees, or flexible work schedules, the intent is to allow workers who wish to stay healthy to do so.

Another important reason for asset growth is to shift decisions and consequences to the worker. Economists have demonstrated convincingly that people protect their own funds more carefully than they protect someone else's. Once money is transferred away from company-sponsored benefits and into worker savings, the spending dynamic changes from one of entitlement to one of protection. Like the other currents, having something to protect extends to positive behaviors elsewhere. The more a worker has to protect, the more he will consider the consequences of health risks.

Current Type 4: Ownership of Decisions (Freedom to Choose)

For any of the previous currents to take full effect, employees must have the authority to make decisions about their own behavior.

Sometimes companies sabotage the strength of their other currents by creating rules or barriers that interfere with workers' choices.

As an example, a company may offer shared rewards for performance, but implement such tight rules regarding how work is done that workers do not feel able to influence outcomes. Poorly-designed shared rewards can actually discourage desired behaviors. As such, workers should be involved, at least conceptually, in how performance incentives are defined. What can the worker influence? Can he be held accountable?

Ways that companies can strengthen employee ownership of decisions:

- Offer consumer-directed health plans (which include a high deductible and HSA) that allow employees to spend their money on services they value.
- Emphasize on output instead of process encourages creativity and efficiency in reaching goals.
- Allow employees to vote on the services they want covered in their benefits package.
- Allow flexible work settings that permit employees to manage their time while meeting aggressive performance goals.

The more choices and ownership employees can be given, the more shared rewards, shared responsibilities, and asset growth will produce optimal human capital performance.

Currents, Life Preservers and Hooks: Implications for Corporate Programs and Initiatives

Currents

Seen as a collective current, the directional influence of policies described above provides a framework for understanding why company initiatives succeed or fail.

In short, when the current flows in a positive direction, programs and initiatives that encounter the current are likely to benefit from the positive momentum that already pulls everyone toward optimal human capital performance.

Force	Created By	Scope of Effect
Current	Incentives	Everyone, All the Time

Life preservers

In contrast to a current which affects all workers all the time, when companies target certain groups of workers with new programs, this equates to throwing a life preserver into the river to try and pull them in a desired direction (fewer absences, better performance, improved health). Inevitably, the intervention will have different effectiveness depending on the company, because each company has a different current. Essentially, if the current pulls the same direction as the new program, it will work. If not, no program is likely to overcome its force.

Force	Created By	Scope of Effect
Life Preserver	Person-Focused Assistance	Some People at Specific Times

Hooks

Programs that try to tackle specific problems that interfere with performance are like hooks. Focused on the specific issues, hooks attempt to move obstacles out of the way so they can no longer obstruct progress. A company may offer training on issues like how to handle stress, exercise more often, and manage diabetes. Though well-intended, hooks have minimal power against the force of a counter-flowing corporate current.

Force	Created By	Scope of Effect
Hooks	Problem-Focused Programs	Specific Issues in Some People at Specific Times

Fortunately, employers have extraordinary influence over worker performance if they acknowledge that incentives drive behavior.

Policy Implications

While a simple analogy, the concept of currents has profound policy implications for organizations. These include:

- All organizations should assess the direction and strength of these four currents. By simply acknowledging the direction and measuring the force of policies that determine incentives for behavior, companies can avoid the frustration caused by an invisible and misunderstood corporate current.

- Next, in an incremental fashion, organizations will benefit from shifting the direction and strength of each current toward optimal human capital performance. Most steps, such as those recommended above, target policies in compensation and health benefits. From our experience, these shifts, should be cost neutral, balancing increased shared reward and asset growth with decreased benefits spending from shared responsibilities, improved performance and optimal staffing levels.

- Policy decisions, which are often made by different people in different departments, must be coordinated strategically to avoid creating conflicting currents.

- Current investments in programs targeted at people (life preservers) or specific behaviors (hooks) should be re-evaluated in the context of broader incentives. Performance of these programs will be determined to a great extent by their alignment with incentive currents. Until currents are aligned, these investments may be inffective.

The lesson of the river

Although often invisible, currents exert a collective force on performance and business success. By understanding currents, decision makers learn why some efforts to encourage or modify worker behaviors don't work and why others do.

In today's competitive markets, no company can afford to ignore the underlying currents that most influence optimal human capital performance. Fortunately, employers have extraordinary influence over worker performance if they acknowledge that incentives drive behavior. Every company has the opportunity to harness the power of currents, avoid spending on less effective intervention programs, and put more incentive money into the pockets of employees. In this way, shared rewards, shared responsibilities, personal asset growth and ownership of decisions create a current that advances employers and employees together, making high performance a mutual reality.

And for those companies unaware of powerful negative currents pulling them away from optimal human capital productivity? Progress will remain difficult, investments wasted, setbacks common, and solutions elusive. Imagine if corporate success could be achieved by simply "going with the flow." With aligned currents in place, it can.

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